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**CHINESE BANKRUPTCY LAW IN AN
EMERGING MARKET ECONOMY: THE
SHENZHEN EXPERIENCE**

**FINDINGS FROM INTERVIEWS WITH JUDGES
FROM THE BANKRUPTCY DIVISION OF THE
SHENZHEN INTERMEDIATE PEOPLE'S COURT
AND BANKRUPTCY PRACTITIONERS IN
SHENZHEN***

XIANCHU ZHANG**
CHARLES D. BOOTH***

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INTRODUCTION

In 1986, the People's Republic of China ("China") enacted its first national bankruptcy law, the Law of the People's Republic of China on Enterprise Bankruptcy (Trial Implementation) (the "Chinese Bankruptcy Law"),¹ as part of an emerging legal framework for the country's transition from a planned economy to a market economy. At the time of its enactment the bankruptcy law was considered a significant political and economic breakthrough that was necessary to apply some market pressure on China's State-Owned Enterprises ("SOEs") to force them to become more efficient.² However, the rapid development of economic reforms in China soon exposed serious limitations in the Chinese Bankruptcy Law.

First of all, the law applies only to SOEs and not to Chinese economic organizations generally. Secondly, since the law was enacted before China pursued further economic reforms beginning in 1993,³ many of the bankruptcy law provisions guaranteeing government involvement and control began to conflict with the introduction of market-centered rules. Thirdly, relatively few bankruptcy cases have been brought under the 1986 law.⁴ At first glance, this low number appears surprising given the weak financial position of SOEs generally. For example, a national survey in 1997 of 14,923 large and mid-sized SOEs revealed that 40.5% were in the red with total losses of RMB 58.9 billion; and the situation in 1998 was even

¹ Law of the People's Republic of China on Enterprise Bankruptcy (Trial Implementation), Standing Committee of the National People's Congress, Dec. 2, 1986 [hereinafter the Chinese Bankruptcy Law]. For an English translation, see General Office of the Legal Commission under the Standing Committee of the National People's Congress (compilation), *LAW OF THE PEOPLE'S REPUBLIC OF CHINA (CIVIL AND COMMERCIAL LAWS)* 684-95 (1998).

² For a detailed review of the legislative history and the controversies encountered, see CAO SIYUAN, *THE STORM OVER BANKRUPTCY* (in Chinese, 1987). An English translation appeared in installments in *CHINESE LAW & GOVERNMENT* (Jan.-Feb. & Mar.-Apr. 1998).

³ In 1993, following Deng Xiaoping's southern tour in which he called for bold economic reforms, the Constitution of the PRC was amended, thereby legitimizing the practice of a socialist market economy. See Article 7 of the Constitutional Amendment of 1993.

⁴ According to the statistics of the Siyuan Consulting Firm (a firm specializing in bankruptcy and mergers and acquisitions), from 1989 to 1996 only 11,580 bankruptcy cases were accepted by all levels of the People's Court throughout China. CAO SIYUAN, *DANGSHUO ZESHUO (SAY WHAT WE SHOULD SAY)* 156 (in Chinese, 1998). To put this number in perspective, this low number of cases occurred at a time when there were over eight million enterprises and commercial households registered in China (pre-1996).

worse.⁵ Although SOE performance improved throughout 2000, the non-performing loans owed by SOEs to state-owned banks are still estimated to be 25-50% of their total lending.⁶ These figures demonstrate that before the Chinese Bankruptcy Law can be "strictly" applied to all insolvent SOEs, the Chinese government must first address two other related problems: (1) the massive level of unemployment that would result and its potentially destabilizing effect on social stability,⁷ and (2) the possible collapse of China's state-owned banks.⁸

The fourth limitation pertains to the Chinese Bankruptcy Law itself. The law is clearly inadequate for many of the problems and issues that arise in bankruptcy cases. With only forty-three short articles, the law is too general and often vague. The Chinese Supreme Court has tried to remedy the situation by issuing a comprehensive interpretation with seventy-six articles,⁹ but this is not a long-term solution.

To address these limitations,¹⁰ the Chinese government began a review of the Chinese Bankruptcy Law in 1994, and a comprehensive first draft of a new law was completed in 1995. However, certain conditions (primarily the problems related to unemployment and potential social instability) caused the draft to be shelved with the national legislature. The drafting process only resumed in 1998,¹¹ and it is now continuing.¹² The latest

⁵. Qiu Xiaohua & Others, *Dazhong Xing Guoyou Qiye Yunying Xingshi Burong Leguan (The Operational Conditions of Large and Mid-sized State Owned Enterprises Are Not Bright)*, 2 ZHONGGUO GUOQING GUOLI (STATE CONDITIONS) 21 (in Chinese, 1999).

⁶. Pauline Loong, *What WTO Means for Chinese Banking*, ASIAMONEY 20, 21 (July/Aug. 2000). The level of lending to SOEs by state-owned banks in earlier years has been estimated to be as high as 75%.

⁷. In fact, the Chinese government is in the process of enacting social security legislation.

⁸. According to World Bank analysis, China's long-term fiscal sustainability has been threatened by the contingent liabilities of the banking sector arising from the SOE reform. The World Bank believes that the problems are larger than official statistics suggest and that long-term fiscal stability depends largely on how the government addresses them. WORLD BANK, CHINA: WEATHERING THE STORM AND LEARNING THE LESSONS 50 (1999).

⁹. Printed in the Research Office of the Supreme People's Court (compilation), ZHONGHUA RENMIN GONGHEGUO ZUIGAO RENMIN FAYUAN CIFA JIESHI QUANJI (THE ASSEMBLAGE OF JUDICIAL INTERPRETATIONS OF THE SUPREME PEOPLE'S COURT OF THE PRC), Vol. 1 (1949-1993) (in Chinese, 1994) [hereinafter SUPREME COURT'S OPINIONS].

¹⁰. Due to space limitations, this article will not provide a detailed discussion of other defects in the Chinese Bankruptcy Law. For further discussion of these matters, see Roman Tomasic, Angus Francis, & Kui Hua Wang, Ch. 2, *China*, in ROMAN TOMASIC & PETER LITTLE (eds.), *INSOLVENCY LAW & PRACTICE IN ASIA* 21-63 (1997); Ronald Winston Harner, *Insolvency Law and Reform in the People's Republic of China*, 64 FORDHAM L. REV. 2563-2589 (1996); Steven L. Seebach, *Bankruptcy Behind the Great Wall: Should U.S. Business Seeking to Invest in the Emerging Chinese Market be Wary?* 8 TRANSNAT'L LAW. 351-373 (1995).

¹¹. In the interim, the State Council adopted a national policy to prefer mergers and acquisitions to bankruptcy in the reform of SOEs. See §9 of the State Council Supplementary Notice on Trial Implementing Mergers & Acquisitions and Bankruptcy of State-Owned Enterprise and Reemployment of Their Workers in Certain Cities, Mar. 2, 1997 [hereinafter March 1997 State Council Supplementary Notice], published in 8 ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN

draft of a new bankruptcy law (the "New Chinese Bankruptcy Law") was completed in December 2000 and has been released for internal comments.¹³

Although China is a country based on centralized state authority where the national law applies to all the regions within the mainland, the Constitution does recognize certain local legislative powers.¹⁴ Also, decentralization in the course of pursuing economic reforms has further fueled local governments' efforts to develop their own practices in implementing the national laws according to their own needs.

Against this backdrop of the national bankruptcy law, the bankruptcy practice in the Shenzhen Special Economic Zone (the "Shenzhen SEZ" or "Shenzhen") offers an interesting and informative comparison and perhaps some lessons for China in reforming its national bankruptcy law. To gain a clearer understanding of Shenzhen insolvency law, the Faculty of Law at the University of Hong Kong ("HKU") and the Department of Economic Law at the China University of Politics and Law in Beijing ("CUPL") conducted interviews of members of the Shenzhen judicial, legal, and political branches who are familiar with bankruptcy law and practice in Shenzhen.¹⁵ These interviews were conducted from February 16 to 18, 2000, by team members from HKU¹⁶ and CUPL¹⁷ as part of a joint research project.¹⁸

The Shenzhen investigation started with a half-day meeting with six of the ten judges of the Bankruptcy Division of the Shenzhen Intermediate People's Court (the "Shenzhen Bankruptcy Court"), including a Deputy

GONGBAO (THE BULLETIN OF THE STATE COUNCIL OF THE PRC) 312, 317 (in Chinese, 1997). It was stated that the policy to encourage mergers and acquisitions should be further implemented with preferential treatment and relaxed restrictions.

¹² See Wang Weiguo, *Adopting Corporate Rescue Regimes in China: A Comparative Survey*, 3 AUSTRALIA J. CORP. L. 234 (1998). In 1998, the enactment of a new bankruptcy law was listed in the Legislative Plan of the new National People's Congress as an unfinished project of the previous congress. See WANG WEIGUO, PO CHAN FA (BANKRUPTCY LAW) 43-44 (in Chinese, 1999).

¹³ The Draft New Chinese Bankruptcy Law (Dec. 2000) (on file with the authors).

¹⁴ Article 100 of the Constitution of the PRC of 1982. For an English Translation, see the BUREAU OF LEGISLATIVE AFFAIRS OF THE STATE COUNCIL OF CHINA (compilation), THE LAW AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA GOVERNING FOREIGN RELATED MATTERS (1949-1990) 295 (1991).

¹⁵ Since the meetings were conducted in a free-style discussion with a question-and-answer format, it is difficult to identify each participant's words. Thus, this article consolidates the views and comments of the participants. The authors are responsible for all errors and misunderstandings, if any, arising from this report of the discussions.

¹⁶ Including the co-authors and Liu Nanping. Non-attending team members included Philip Smart (who helped design the questionnaires) and Say Goo.

¹⁷ Including Dean Wang Weiguo and five of his colleagues. Dean Wang is also a member of the Drafting Group of the New Bankruptcy Law of China.

¹⁸ The Shenzhen interview project was the first area of collaboration pursuant to an Insolvency Research Agreement entered into by the Faculty of Law at the University of Hong Kong and the Department of Economic Law at the China University of Politics and Law in March 1999. Further interview projects will be held in other Chinese cities over the next few years.

President of the Court. The research group then interviewed six bankruptcy practitioners who frequently serve as members of liquidation committees in bankruptcy cases (the “liquidators”).¹⁹ The final meetings involved six lawyers who engage in general bankruptcy practice in Shenzhen and three officers from the Legal Affairs Committee of the Standing Committee of the Shenzhen People’s Congress, which is the local legislature.

Part I of this article provides an overview of Shenzhen bankruptcy law and draws comparisons with the national bankruptcy law. Part II focuses on the practice of insolvency law in Shenzhen and sets out the results of the interviews conducted in Shenzhen in February 2000. Part III concludes with some overall observations.

I. AN OVERVIEW OF SHENZHEN BANKRUPTCY LAW AND COMPARISONS WITH THE NATIONAL LAW

Established as an SEZ in the early 1980s, Shenzhen started to implement an open-door policy and to engage in market-based economic practices ahead of other regions of mainland China. As a result, in Shenzhen the driving force behind economic development was not the state sector, but rather was a diversified structure that included both foreign investment enterprises and domestic Chinese private firms. Local rules were enacted in Shenzhen to deal with the issues arising from this practice. Shenzhen had its own Bankruptcy Provisions on Foreign Related Companies in 1986 (the “Shenzhen Bankruptcy Provisions”),²⁰ even before the promulgation of the national Chinese Bankruptcy Law. In 1992, with the aim of facilitating market development in Shenzhen, the Standing Committee of the National People’s Congress delegated to the Shenzhen SEZ special legislative power to adopt regulations applicable to the SEZ, provided they did not contradict the national Constitution or the basic principles of the national laws and

¹⁹ One of the lawyers, Mr. Wang Fuxiang, has published a book based on his personal experiences: WANG FUXIANG, POCHAN QINGSUAN YU LUSHI SHIWU (BANKRUPTCY LIQUIDATION AND LAWYERS’ PRACTICE) (in Chinese, 1998) (containing 53 standardized liquidation documents including notices, reports, confirmation letters, various agreements, and petitions, as evidence of the streamlined liquidation practice in Shenzhen. Another Shenzhen lawyer, who did not participate in the meetings, has also published a book. GUO XINGYA, POCHAN QINGSUAN ZHONGDE LUSHI SHIWU (LAWYERS’ PRACTICE IN BANKRUPTCY LIQUIDATION) (in Chinese, 1996).

²⁰ The Shenzhen Bankruptcy Provisions on Foreign Related Companies were adopted by the Standing Committee of the Guangdong People’s Congress on November 29, 1986 [hereinafter the Shenzhen Bankruptcy Provisions], and published in the General Office and the Economic Law Research Centre of the Guangdong Government (compilation), GUANGDONG SHENG FAGUI GUIZHANG HUIBIAN (COLLECTIONS OF LEGAL REGULATIONS AND PROVISIONS OF GUANGDONG) (1984-1986) 185-195 (in Chinese, 1997).

decrees.²¹ The Shenzhen SEZ soon took advantage of this delegated power and, on November 10, 1993, enacted the Shenzhen SEZ Enterprise Bankruptcy Regulations (the "Shenzhen Bankruptcy Regulations") to replace the 1986 Shenzhen Bankruptcy Provisions.²² As such, in Shenzhen the local Bankruptcy Regulations shall be applied first, as long as the application does not violate the national law. However, in this regard, because of the lack of judicial review in China, the local court's ability to judge the legitimacy of the Shenzhen local enactments is limited.²³

Comparisons with the national law

As a later market-centered enactment, the Shenzhen Bankruptcy Regulations differ from the Chinese Bankruptcy Law in many respects. First of all, the scope of the Shenzhen law is much broader than the national law; the Regulations create a uniform system applicable to all enterprises that either are registered or reside within the SEZ.²⁴ In bankruptcy proceedings in Shenzhen, the Shenzhen Court may apply the Shenzhen Bankruptcy Regulations to the extent that they do not conflict with the principles

²¹. For an English translation of the Standing Committee's delegation of this power, see the Legislative Affairs Commission of the Standing Committee of the National People's Congress (compilation), *THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA* Vol. 5, 524 (1993, amended 1999). In this regard, it should be noted that according to art. 100 of the national Constitution as mentioned above, other local enactments may not contradict the Constitution, national laws or administrative regulations. As such, the discretion of the delegated legislative power granted to the SEZ is broader than the normal local legislation. This special power was further confirmed in a recent Law of Legislation that was adopted this year. Art. 65 of the Law of Legislation of 2000. For an English translation, see Supplement No. 5 *China Economic News* 1-8 (2000).

²². For an English translation, see CCH ASIA PACIFIC (compilation), *CCH CHINA LAWS FOR FOREIGN BUSINESS (SPECIAL ZONES AND CITIES)*, Vol. 1, §71-055 at 25014-374 (1999) [hereinafter *CHINA LAWS FOR FOREIGN BUSINESS*].

²³. Despite the fact that China is moving towards a market economy, the Communist Party and the national government continue to play a crucial role in the country's economic life and in the resolution of disputes. The subordinate role of law and the judiciary in the governance process remains an important feature of the Chinese legal system. As a result, judicial review of administrative actions is restricted to "concrete" administrative acts. Consequently, the adoption of decrees and policies is exempted. For a recent discussion, see Donald J. Lewis, *Governance in China: the Present and Future Tense*, in LAURENCE J. BRAHM (ed.), *CHINA'S CENTURY: THE AWAKENING OF THE NEXT ECONOMIC POWERHOUSE* 235-43 (2001); and Pitman B. Potter, *China and the WTO: Tensions Between Globalized Liberalism and Local Culture*, 32 *CANADIAN BUS. L.J.* 440, 447-53 (1999). The Law on Legislation of 2000 failed to address this issue and a proposal to establish an independent constitutional committee was rejected. However, the recent accession of China into the WTO has signaled some encouraging changes for the future. In its WTO entry document, China has promised to revise the current laws and regulations; and independent and impartial tribunals will be established to review administrative actions, including enactments. See §78 of WTO: REPORT OF THE WORKING PARTY ON THE ACCESSION OF CHINA (WT/WIN (01)/3), Nov. 10, 2001, available at <http://www.wto.org>.

²⁴. Shenzhen Bankruptcy Regulations, art. 2.

underlying the Chinese Bankruptcy Law.

Secondly, the Shenzhen Bankruptcy Regulations include a simplified bankruptcy test. Under the Chinese Bankruptcy Law, the insolvency tests for determining whether an SOE is bankrupt include (1) whether an SOE is able to pay its debts when due and (2) whether the incurring of serious losses by an SOE were a result of poor management, in the case of a creditor's petition.²⁵ By contrast, Article 3 of the Shenzhen Bankruptcy Regulations does not include an equivalent of the second prong of the test and instead stipulates that a bankruptcy order shall be entered only if an enterprise is unable to pay its debts when due. This simplified definition of bankruptcy avoids the need for a bankruptcy court to inquire into the difficult, and often disputed, matters involving the management of insolvent SOEs.

Thirdly, the Shenzhen Bankruptcy Regulations focus more on the application of market-oriented principles than on the relationship between an enterprise and the relevant government authority. Although the National Bankruptcy Law includes language that appears to require government approval in only certain situations,²⁶ in practice the bankruptcy of any SOE must be approved by various state authorities.²⁷ It has therefore been observed that the national SOE bankruptcy law "is essentially a procedure to be applied by the Government, not invoked at the option of debtors or creditors."²⁸ Moreover, once a case has been commenced under the Chinese Bankruptcy Law, unless the upper-level state authority of the debtor SOE takes the initiative to reorganize the SOE,²⁹ a settlement proposal will not be

²⁵ Chinese Bankruptcy Law, art. 3. Article 3 also provides that where creditors petition for bankruptcy, an SOE shall not be declared bankrupt where (1) the SOE is a public enterprise or an enterprise with an important relationship to the national economy and to the people's livelihood and the relevant government department provides financial support to, or adopts assistance measures for, the SOE and (2) the SOE has obtained a guarantee and repays its debts within six months from the date of the petition. Also, in cases commenced by creditors, liquidation will be stayed where the governmental department concerned applies for reorganization and where the creditors' meeting results in a reconciliation agreement. In addition, Article 8 of the national law provides that an SOE, as a debtor, may not file a voluntary bankruptcy petition without first getting approval from its upper-level government authority.

²⁶ *Id.*

²⁷ When receiving a bankruptcy petition against an SOE, the People's Court would require the approval of the relevant government authorities as a necessary condition of reception, regardless of the business nature of the SOE concerned, or of whether or not the case had been commenced by the debtor or creditors. SUPREME COURT'S OPINIONS, *supra* note 9, §5(5) at 1867. Furthermore, Article 37 of the Regulations on Transformation of Operational Mechanisms of Industrial Enterprises Owned by the Whole People, promulgated by the State Council on July 23, 1992, states that the government should provide an SOE with financial aid or other supporting measures if it considers the bankruptcy of the enterprise to be inadvisable. The Regulation is published in 22 ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO (THE BULLETIN OF THE STATE COUNCIL OF THE PRC), 837, 847 (in Chinese, 1992).

²⁸ Donald C. Clarke, *Regulation and its Discontents: Understanding Economic Law in China*, 2 STAN. J. INT'L L. 283, 299-300 (1992).

²⁹ Chinese Bankruptcy Law, arts. 3 & 17. In this regard, the Supreme People's Court mandates

available. In contrast, Shenzhen bankruptcy practice is subject to much less administrative control. Under the Shenzhen Bankruptcy Regulations, government approval is not a necessary condition for an enterprise bankruptcy or for a settlement in a bankruptcy proceeding. Once a case has been commenced, Article 25 of the Shenzhen Regulations provides the debtor itself with the decision whether to propose a settlement. Moreover, Article 28 empowers the court to examine and approve the settlement proposal and Article 30 mandates the court to appoint a supervisory committee composed of professionals, including accountants and lawyers, to monitor the implementation.

Fourth, the Shenzhen Bankruptcy Regulations include additional bankruptcy procedures and provisions that are not available in the national Bankruptcy Law, including: rules for the court to supervise the liquidation committee;³⁰ a special chapter dealing with small bankruptcy cases;³¹ and more detailed rules governing set-offs.³²

Lastly, the judicial practice in Shenzhen for handling bankruptcies differs from the practice followed by other courts under the Chinese Bankruptcy Law. In 1993 China's first bankruptcy judicial division was established within the Intermediate People's Court of Shenzhen. This has led to the development in Shenzhen of a specialized judicial branch with perhaps the most insolvency experience of any judicial division in China. Since its formation, the Shenzhen Bankruptcy Court has led other Chinese courts in three categories, namely: (1) the number of bankruptcy cases accepted per annum; (2) the number of bankruptcy cases heard per annum; and (3) the total number of bankruptcy cases handled per annum.³³

The experience gained from handling this heavier workload has led the Court to streamline its management of bankruptcy cases in a variety of ways. For example, the Court has adopted the Responsibility and

that where a bankruptcy petition is filed against an SOE by a creditor, the upper-level state authority of the SOE shall submit a settlement plan to the court and to the creditors' meeting if it decides to consolidate the SOE. SUPREME COURT OPINIONS, *supra* note 9, §33 at 1868. The State Council also encourages local governments to reorganize bankrupt SOEs by replacing management, changing the capital model, or transforming the SOE organizational structure with supporting measures if they believe the bankruptcy is inadvisable. See §8 of the State Council Notice on Issues Concerning Trial Implementation of State-Owned Enterprise Bankruptcy Law in Certain Cities, Oct. 25, 1994, published in the Research Office of the Supreme People's Court (compilation), JINGXUAN SIFA WENJIAN (IMPORTANT SELECTED JUDICIAL DOCUMENTS), vol. of Economic Law, 437 (in Chinese, 1997).

³⁰. Shenzhen Bankruptcy Regulations, arts. 54 and 55.

³¹. *Id.* Ch. 6.

³². *Id.* Art. 67.

³³. The then President of the Shenzhen Bankruptcy Court, Xu Liangdong, discusses the judicial experience of the Shenzhen Bankruptcy Court over the past few years in a recent book: XU LIANGDONG, POCHAN ANJIAN SHENLI CHENGXU (TRIAL PROCEDURES OF BANKRUPTCY CASES) (in Chinese, 1997).

Operational Procedures of the Bankruptcy Division (the "Bankruptcy Division Procedures") and the Time Limitation and Certain Checking Points standards;³⁴ and has developed thirty standardized judicial documents including notices, inquiries, appointments, and rulings applicable to different stages of bankruptcy proceedings.³⁵ In addition, the judicial documents adopted by the Shenzhen Bankruptcy Court also fill in some gaps in the national framework. For example, the Chinese Bankruptcy Law fails to provide a time limit for a court to approve a settlement agreement; but Point 10 of the Time Limitation and Certain Checking Points requires the court to render its decision within ten days.

In sum, the Shenzhen bankruptcy regime has improved the Chinese Bankruptcy Law in many ways, in part through the adoption of market-orientated economic principles and the development of a more liberal piece of legislation. Judges sitting on the Shenzhen Bankruptcy Court are more experienced and specialized in dealing with bankruptcy cases than are their counterparts elsewhere in China. However, on the other hand, the Shenzhen Bankruptcy Regulations are not a panacea and themselves suffer from many limitations, which are discussed in Part II below.

II. SHENZHEN BANKRUPTCY PRACTICE: THE PERSPECTIVE OF JUDGES, LAWYERS, AND LEGISLATORS

Bankruptcy statistics

From 1995 to 1998, the Shenzhen Bankruptcy Court accepted 316 bankruptcy cases. Of these cases, approximately 20% involved SOEs as debtors and another 20%, foreign-related enterprises. Of the cases involving SOEs, only one recorded case involved a large-sized SOE bankruptcy, and that case was too complex to allow for the reaching of a final resolution by the time of the interviews. Although these numbers may not sound terribly onerous by Western standards, the lack of supporting institutions (discussed below) makes bankruptcy cases in Shenzhen much more difficult to handle than other cases. Point 55 of the Bankruptcy Division Procedures explicitly recognizes that bankruptcy cases consume great amounts of both time and effort, as they involve many different types of economic disputes and legal proceedings. A deputy head of the Shenzhen Bankruptcy Court pointed out that the minimum length of time to complete a bankruptcy case in the Division was nine months and many uncompleted cases had been on-going

³⁴. Both judicial instruments are printed as annexes in Xu's book, *id.* at 415-429.

³⁵. *Id.* at 255-286.

for over two years. Overall, with the exception of bankruptcy cases being handled under summary procedures, the average completion time for bankruptcy cases in Shenzhen is two years.³⁶ A general formula has been developed in Shenzhen to calculate the approximate amount of man-hours needed for a bankruptcy: the handling of one bankruptcy case is treated as the equivalent of eight other cases; in small bankruptcy cases, the ratio is reduced to the equivalent of four.³⁷

The judges noted that the ongoing restructuring of the Shenzhen economy has led to a number of business failures, which accounted in part for the increase in the rate of bankruptcies in Shenzhen. Since 1993, the SEZ government has been upgrading the city's industrial structure to include more technology-intensified and service-based businesses. As a result, many labor-intensified manufacturing and processing plants were required to either "transform" themselves or move out of Shenzhen.³⁸ The judges noted, however, that the overall number of formal bankruptcy cases dealt with by the judiciary accounted for only a small percentage of these corporate "transformations." Many insolvent firms ended their operations without any liquidation or formal dissolution. Rather, their owners or investors just disappeared, and earned the name of "three no enterprises": no business place, no books of account, and no assets. In many instances of this kind, the debtors were residents of Hong Kong and fled to foreign jurisdictions where the People's Court could not reach them.

The average recovery rate for creditors in bankruptcies in Shenzhen is not high. In a typical case, after the claims of secured creditors and workers have been satisfied, there is little left to pay general unsecured creditors. The average rate of recovery for creditors in Shenzhen is less than 10%. In at least one case the rate of return was as low as 0.026%.³⁹ On the

³⁶ Xu *supra*, note 33, at 35. A two-year period greatly exceeds the average for ordinary civil litigation in China. Under Article 135 of the Civil Procedure Law of PRC, a case being handled in a trial of first instance should normally be completed within six months, and certain special situations may allow for a six-month extension. Any further extension of civil proceedings must be approved by the upper-level People's Court.

³⁷ Xu, *supra* note 33, at 427.

³⁸ For a discussion of the enforcement of this policy, see Zhang Xianchu, *Economic Legislation in the Pearl River Delta* in Joseph Y. S. Cheng (ed.), *THE GUANGDONG DEVELOPMENT MODEL AND ITS CHALLENGES* 133-134 (1998).

³⁹ These figures apparently echo the national conditions. According to a survey of 131 SOE bankruptcy cases in the first half of 1996, the average rate of recovery was approximately 10%. Cao Siyuan (ed.), *JIANBING YU POCHAN CAOZOU SHIWU (PRACTICE OF MERGERS AND ACQUISITIONS AND BANKRUPTCY)* 391 (in Chinese, 1997). More recently, according to Judge Li Guoguang, a Vice President of the Supreme People's Court, the average rate of recovery of all SOE bankruptcy cases in 1997 was 6.63%, with many cases ending up with zero distribution. See his speech at the National Working Meeting of SOE Bankruptcy Trials on April 1, 1998, printed in the *SECOND ECONOMIC TRIAL DIVISION OF THE HIGH PEOPLE'S COURT OF JILIN PROVINCE* (compilation), CHULI POCHAN ANJIAN SHIYONG DE FALU HE WENSHU YANGSHI (APPLICABLE LAWS AND DOCUMENT SAMPLES

upper end, there were cases where up to 20% was repaid, but these cases were quite rare. One reason given for the low rate of payment is that the liquidation committee is usually unable to find purchasers for the corporate property, and another is that the assets of the debtor often disappear during the period between the filing of a bankruptcy petition and the appointment of a liquidation committee. The problems of the liquidation committee will be addressed in more detail below.

Relationship with government authorities

Although, as noted above, the Shenzhen Bankruptcy Regulations do not require the approval of relevant state authorities for the bankruptcy of a state-owned or controlled company, some administrative agencies have continued to assert the application of a state policy requiring such approval. However, now that many state authorities have become controlling shareholders of many incorporated SOEs, the state authorities can now also assert approval rights at the shareholder level. In other words, a state authority may now wear two hats at the same time, as both the majority shareholder of a company and as the policy maker with responsibility for the market economy. Thus, many of the interviewees noted that it would be absurd (at least in a case commenced by a debtor company) for a state authority to be responsible for protecting state assets, while at the same time being under a legal duty to deal with creditors fairly.

However, once a case is commenced, the government frequently plays a significant role. The Shenzhen bankruptcy judges consider government support and assistance as necessary conditions to the smooth handling of bankruptcy cases by the judiciary. The judges identified certain key areas where they have to coordinate closely with the government, including: determining the amount of workers' settlements; disposing of state assets; and transferring land use rights.⁴⁹ They also noted, however, that

IN TRIALS IN BANKRUPTCY CASES), at 68 (in Chinese, 2000).

⁴⁹. Many SOEs have used state land (without being required to pay compensation to the government) through allocation under the planned economy. Some SOEs have even used their land use rights as capital contributions when establishing joint ventures with foreign investors and other firms. After the real estate market in China officially opened at the end of 1980s, land use rights became marketable, creating valuable assets for many SOEs. When many of these SOEs became bankrupt, difficult issues arose in the bankruptcy cases as to how to include (and value) these land use rights as part of the property of the estate for the purpose of making distributions to creditors. The government as the landowner may demand control over the purpose of the land use based on the government development plan, the transfer price, and other terms of transfer. A notice of the State Council states that the funds to resettle workers of a bankrupt SOE shall first be allocated from the proceeds of the land right transfer, even if the right of land use has previously been provided as

government involvement, at times plays a negative role. Some of the judges claimed that the government sometimes attempts to exert political influence over the judiciary. For example, they mentioned judicial proceedings in which government authorities intervened in an effort to protect state assets. This put the judges in a very difficult position for deciding whether special protection should be given to the state interest to the detriment of other creditors.

Another interesting issue is to what extent the judiciary may have to accept the conclusion or decision of an administrative authority concerning the bankruptcy of a state-owned or controlled company. Currently, within the State Administration of Industry and Commerce ("SAIC"), which is the state authority in charge of business registration and cancellation, there is a liquidation department responsible for liquidation proceedings in a non-bankruptcy context. But once the SAIC finds an enterprise to be insolvent, it is required to transfer the case to the People's Court. Sometimes, certain preliminary rulings may even have been made. The issue of whether the judiciary should be bound by these administrative holdings poses a challenge in those cases where the judiciary might reach a different conclusion as to whether the company is, in fact, insolvent. In the Chinese socialist system, there is no tradition of judicial independence and the judiciary does not have a track record of overruling administrative decisions. Moreover, a judicial refusal to take a case referred to it by the SAIC may leave the parties concerned caught in the middle of a dispute between two powerful state organs. However, the docile acceptance of such cases from the SAIC would surely jeopardize the judicial standards and the professional independence of the judiciary.

In other areas as well, the unclearly defined relations between the various state organs and the bankruptcy court may cause complications in the administration of bankruptcies. The serious problems arising in regard to the investigation and prosecution of fraud are discussed below. Related difficulties arise in regard to preventing debtors from escaping from their financial obligations and absconding from the mainland. In this area, the Shenzhen judges feel that their powers are limited, and they gave an example: according to a circular of the Supreme People's Court issued in 1987, a People's Court may enter an order preventing a resident of Hong Kong or Macau who has no assets in the mainland for execution and who refuses to provide security for his unsettled debts from leaving the mainland;⁴¹ however, the judges have found it difficult to implement this

collateral to another party. March 1997 State Council Supplementary Notice, §5, published in 8 ZHONGHUA RENMIN GONGHEGUO GUOWUYUAN GONGBAO (THE BULLETIN OF THE STATE COUNCIL OF THE PRC), *supra* note 11, at 315.

⁴¹. Replies of the Supreme People's Court on Certain Issues Concerning Economic Dispute

circular because of the lack of collaboration among the courts and the public security, border control, and People's Procuratorate offices. For example, they noted several civil cases in which by the time all the state branches in Shenzhen agreed to take preventive action, the debtors concerned had already escaped from the jurisdiction.

Another issue involving the need for cooperation between the judiciary and state authorities concerns the preferential treatment given to SOE workers in comparison to employees of non-state enterprises. It must be borne in mind that the insolvency of an SOE is more like the insolvency of a municipality than of a company.⁴² In the past, an SOE provided its workers not only with working positions, but also with education, housing, and other social security benefits. Thus, bankrupting an SOE has great social implications. To maintain social stability in the light of the significant number of SOE insolvencies in recent years, the government and judiciary have each adopted policies to guarantee the protection of the living standards of workers of bankrupt SOEs. For instance, as noted above, a notice of the State Council states that the proceeds of the land right transfer shall be first used to settle workers of a bankrupt SOE, even if the right of land use has previously been provided as collateral to another party.⁴³ Similarly, the Shenzhen Bankruptcy Court has taken the view that, if possible, after the filing of a bankruptcy petition, workers of SOEs should be paid at least 70% of their normal salary; and after the bankruptcy declaration, workers should be paid according to the minimum living standards adopted by the Shenzhen Government. In addition, certain additional living allowances should be paid during the liquidation, at a rate based on the enterprise's financial condition.⁴⁴ Also, according to a State Council Notice, the settlement standard of SOE workers shall generally be three times that of the local workers' average salary of the previous year.⁴⁵ However, no such standards are available to settling workers of enterprises not owned by the state, and employees in non-state sectors have been complaining about this lack of equal treatment. In some cases, the judges and liquidation committees have to exercise their powers and influence to persuade and pressure non-SOE workers and other parties concerned to compromise in order to uphold social stability.

The complexities involving the payments to workers are further

Cases Involving Interest of Hong Kong and Macau, Oct. 19, 1987, published in the SUPREME COURT'S OPINIONS, *supra* note 9, at 1899.

⁴² Thus, to put it in a U.S. context, a bankruptcy of an SOE is more like a Chapter 9, rather than a Chapter 11, proceeding under the U.S. Bankruptcy Code.

⁴³ See *supra* note 40.

⁴⁴ XU, *supra* note 33, at 246.

⁴⁵ March 1997 State Council Supplementary Notice §5, *supra* note 11, at 315.

complicated by conflicts over taxes. A bankruptcy liquidation usually bases its payments to creditors on the company's books of account, but in many cases these figures are quite different from those of the state tax authorities. Moreover, if the taxation authorities do not get repaid in full, they will not give permission for the bankrupt company's business registration to be cancelled, thereby making it difficult, if not impossible, to bring the bankruptcy proceedings to a conclusion. This practice appears to conflict with the modern trend favoring the abolition of taxation priorities in insolvency.⁴⁶

Bankruptcy fraud and crimes

Matters involving bankruptcy fraud and crimes were raised independently by the judges, liquidators, and bankruptcy lawyers, and were among the most serious issues mentioned in the interviews. There was a strong consensus as to the growing ineffectiveness of both the Chinese Bankruptcy Law and Shenzhen Bankruptcy Regulations, and the related rules and procedures, in dealing with these matters. Debtors have been getting quite clever in carrying out well-planned fraudulent schemes to dissipate corporate assets to the detriment of creditors. The success of their schemes arises from a variety of factors including the lack of coordination between the judiciary and government authorities, the inadequacy of the bankruptcy laws themselves, and the lack of bankruptcy court jurisdiction to police fraudulent activities.

The lawyers noted that in a growing number of cases the commencement of a bankruptcy proceeding itself was part of an overall scheme to defraud creditors. A common *modus operandi* was for a company to dispose of its assets pre-petition, thereby leaving an empty shell for creditors. In a few of these cases, by the time a bankruptcy petition was filed, the entity was a "three no enterprise."⁴⁷ In at least one such case, these factors led the Shenzhen Bankruptcy Court to refuse to accept the case. It is becoming increasingly common for the perpetrators of these schemes to flee by the time a petition has been presented. The lawyers pointed to several cases involving joint ventures between Hong Kong and mainland parties in which the Chinese partners ultimately had to repay debts undertaken in the

⁴⁶. Getting rid of priorities for taxation authorities forces the authorities to improve their debt collection practices. The evidence from Australia shows that after the Australian taxation authorities lost their priority in insolvencies, the authorities actually increased the amounts collected from debtors in tax arrears.

⁴⁷. According to a recent investigation by the Real Estate Taxation Bureau of Shenzhen, about half of the enterprises in arrears in tax payments are never found when the authority presses for payment. See the report in *Min Pao* (Hong Kong), Nov. 23, 2000, at B16.

name of the joint ventures after the Hong Kong parties disappeared with the funds. Because the perpetrators often flee, by the time the bankruptcy case is commenced, the directors or general managers or managers then in charge often have little knowledge of the insolvent company's operational history. As such, many of them are facetiously referred to as "the last emperor" or "the bankruptcy boss."

Unfortunately, the Shenzhen judges are frequently unable to confront these abuses. Although it is true that the PRC Criminal Law of 1997 includes certain provisions applying to bankruptcy-related crimes, these provisions do not extend to violations of disclosure obligations, the waste or abandonment of property, or bankruptcy fraud.⁴⁸ The separation of powers among the various state organs contributes to the inability of bankruptcy branch of the Shenzhen Court to effectively deal with bankruptcy fraud. Most importantly, since the bankruptcy court is part of the commercial law side of the People's Court it has no duty, or manpower, to conduct criminal investigations. As a result, without the cooperation of the Public Security Department and the People's Procuratorate, a bankruptcy judge is likely to be able to do little even if criminal activities are discovered. On many occasions the liquidation committees have filed a complaint alleging fraud, but it has proven difficult to get evidence and requests to transfer the case to another court were denied due to the lack of direct evidence. There have been some partial successes, however. In one case, an SOE started disposing of its corporate assets and paid RMB 1,000,000 to a creditor after the filing of a bankruptcy petition, but before the appointment of a liquidation committee. The liquidation committee later collected the RMB 1,000,000 and obtained a sanction in the form of a fine of RMB 500 against the legal representative.

Current insolvency practices and procedures exacerbate these problems. For example, as Wang Fuxiang has noted, auditing is only conducted in regard to the assets and accounts of the enterprises concerned, and does not extend to the directors' spending or personal transactions. Without this expanded scope of enquiry, it is often impossible to identify corrupt or inappropriate actions of the directors. Moreover, in the liquidation process, the limited resources and low efficiency does not allow the liquidation committee to verify each and every account or note.⁴⁹ Thus, the greater the number of accounts, the less likely that an irregularity will be spotted in any individual account.

Some local enactments have been made in an attempt to confront these problems, but they too have not been overly successful. For example,

⁴⁸. See Li Yongjun, *Major Issues in the Drafting of the New Chinese Bankruptcy Law*, CHINA L. 74, 76 (Aug. 2000).

⁴⁹. WANG, *supra* note 19, at 41-45.

Article 91 of the Shenzhen Bankruptcy Regulations provides that a legal representative of an enterprise shall not be a legal representative of any other enterprises within three years if he is responsible for the bankruptcy of the enterprise. However, the judges noted that some debtors avoided the application of this provision by gaining control of newly established enterprises through the use of the names of family members. The lawyers also noted that many legal representatives often fail to cooperate with the liquidation committee. Another common problem is the failure of management to keep adequate (or, in some cases, any) books of account. Interestingly, the view of the lawyers was that SOE accounts were generally in better shape than the accounts of foreign joint ventures.

There was a strong consensus among both the judges and the lawyers that new criminal provisions should be added to the Shenzhen bankruptcy law to enable the courts and liquidation committees to more effectively combat criminal and fraudulent activities. Judge Xu Liangdong made similar points in his 1997 book, in which he identifies defects of the current legal bankruptcy regime in dealing with fraudulent bankruptcy schemes, and proposes to improve the regime through future legislation. In particular, he stresses that existing defects have rendered the People's Court incapable of effectively punishing bankruptcy fraud in many cases.⁵⁰ Other Chinese insolvency experts have also addressed this issue and proposed to expand the application of provisions against evasion of property rights in the criminal law to bankruptcy fraud so that the recovery of the assets concerned would not be subject to the statutory limitation of six months.⁵¹ Others believe that specific rules of bankruptcy crimes must be adopted in order to crack down on fraudulent schemes.⁵²

Another suggestion was that provisions should be added to mandate that legal representatives cooperate with the liquidation committees. In fact, in the 2000 draft of the New Chinese Bankruptcy Law, some provisions have been recommended that would allow a bankruptcy court to detain legal representatives when they violate their responsibilities and require them to pay an RMB 5000 fine.

The lawyers also expressed their concern with the growing amount of abuse of the corporate entity. They noted that many companies and subsidiaries are seriously under-capitalized from the very beginning, often

⁵⁰. Xu, *supra* note 33, at 38-41.

⁵¹. TANG WEIJIAN, POCHAN CHENG SU YU POCHAN LIFA YANJIU (STUDY ON BANKRUPTCY PROCEDURES AND LEGISLATION 76-77 (in Chinese, 2001).

⁵². LI SHUGUANG (ed.), ZHONGGUO QIYE CHONGZU CAOZUO SHIWU QUANSHUO (OPERATIONAL PRACTICE OF ENTERPRISE REORGANIZATION IN CHINA, vol. 1, 605-606 (in Chinese, 1997).

using the corporate vehicle as a fraudulent device.⁵³ Other problems arise in regard to complicated schemes involving transactions among affiliates in a corporate family. However, the lack of the common law doctrine of "piercing the corporate veil" in the Chinese company legislation⁵⁴ or of substantive consolidation in the bankruptcy legislation⁵⁵ makes it difficult, if not usually impossible, for creditors to reach the real party responsible for the debts.

Another problem is that some of the relation-back periods prove too short to effectively attack fraudulent transactions, thereby enabling crafty debtors to enter into transactions to the detriment of creditors. Both the Chinese Bankruptcy Law and the Shenzhen Bankruptcy Regulations empower the court to invalidate fraudulent transactions made within six months of the acceptance of the bankruptcy case by the People's Court.⁵⁶ However, in a number of well-planned incidents, as mentioned by the judges and lawyers, responsible parties disposed of enterprise assets in fraudulent transactions more than six months before the commencement of the relevant bankruptcy case, thereby escaping the application of the six-month avoidance period.

Several of the lawyers therefore argued that the liquidation committee should be allowed to enforce avoidance claims occurring outside of the statutory limitation period where the timing problems did not result from the debtor's negligence, but rather from the debtor's fraudulent intention to leave the bankrupt enterprise an empty shell. However, the lawyers suggested that in those cases in which third parties invoke the statutory limitation defense, the court should make its decision by looking into the relations and transactions between such parties and the debtor.⁵⁷ Given that China is a country with a long civil law tradition, the lawyers acknowledged that without explicit legislative criteria, the People's Court may not be able to function on an equitable basis as would the judiciary in a common law jurisdiction.⁵⁸

⁵³. According to the Company Law of 1993 as amended in 1999, a statutory minimum amount of capital that must be actually paid-in is a legal condition for establishing a company, with the exact amount dependent upon the form and purpose of the corporate entity. See Company Law, arts. 23, 25, 26, 27, 28, 78, published in THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA, *supra* note 21, vol. 11, at 298-300, 311.

⁵⁴. For a discussion of this problem, see Zhang Xianchu, *Piercing the Company Veil and Regulation of Companies in China*, in LEGAL DEVELOPMENTS IN CHINA: MARKET ECONOMY AND LAW 129-143 (Wang Guiguo & Wei Zhenying eds., 1996).

⁵⁵. It is noted that the problems involving affiliates are not addressed in the latest draft of the New Chinese Bankruptcy Law.

⁵⁶. Article 35 of the Chinese Bankruptcy Law and art. 18 of the Shenzhen Regulations.

⁵⁷. See also WANG, *supra* note 19, at 136-137.

⁵⁸. Article 186 of the recent draft of the New Chinese Bankruptcy Law apparently tries to

To support their argument in favor of a flexible interpretation of the statutory limitation periods, the lawyers pointed out that changes could be made that are analogous to the treatment of late-registered claims under Article 15 of the Shenzhen Bankruptcy Regulations. Unlike the national law,⁵⁹ the Regulations provide a creditor's lawyers with more room to argue for delayed claim registration. Article 15 states that a creditor that fails to register a claim after the bankruptcy petition is filed shall be deemed to have abandoned its claim. However, this provision shall not apply to a situation where the failure to register is not caused by the creditor's fault, and the delayed filing is made before the distribution of the bankrupt assets. All of the lawyers agreed that this flexible rule is more reasonable. They pointed to an example showing the benefits of this provision in which a Hong Kong creditor was permitted to retain his claim although he missed the registration deadline, because the public notice of the bankruptcy proceeding was only carried in a local Shenzhen newspaper.⁶⁰

The lawyers also identified other areas in which the legislation needs to be changed to combat activities that are part of schemes used by companies on the edge of bankruptcy. For example, it is becoming a common practice in China for a troubled enterprise to force its employees to choose between making contributions to the enterprise and being dismissed. The judges reported a case pending in the Shenzhen Bankruptcy Court in which an enterprise forced 2,000 of its employees to contribute over RMB 70 million to the enterprise to prevent it from becoming bankrupt. Despite each contributor receiving a note evidencing his or her "contribution," the true intention was to circumvent the state restriction on raising capital without state approval. The court is now facing a dilemma as to how to resolve the status of these contributions made by the workers. On the one hand, to treat workers as mere equity holders or as ordinary unsecured creditors would allow the enterprise to benefit from its use of strong-arm tactics and unfair influence, would serve as recognition by the court of the unlawful scheme, and would put the workers in a situation with little likelihood of recovery.⁶¹ On the other hand, to treat the workers as preferred

address this concern by imposing criminal liability for certain fraudulent activities that take place within 12 months of the commencement of the bankruptcy proceeding.

⁵⁹. Article 9 of the Chinese Bankruptcy Law provides that any claims of creditors must be filed within three months of the public notice of the start of the bankruptcy proceedings; otherwise the claims shall be deemed to have been abandoned.

⁶⁰. Since then, the trend is for bankruptcy notices to also be published in the *Renming Faguan Bao* (*People's Court Journal*), a nationally circulated newspaper with a special section for such judicial notices.

⁶¹. Some state authorities have issued documents to stop this practice. For example, in a recent circular the State Economy and Trade Commission prohibited local governments or enterprises from forcing their employees to make contributions to troubled enterprises. See the Notice of the Commission on Issues Concerning Stopping Massive Sales of Small-Scale State Owned Enterprises,

creditors by taking their duress into account would arguably be unfair to existing creditors because it would enable the court to void the capital "agreement" and return the remaining funds to the workers to the detriment of the pre-existing unsecured creditors.

This broad variety of fraudulent and questionable behavior by enterprises has led many of the bankruptcy lawyers and liquidators to note that although the bankruptcy regime is supposed to protect creditors as well as debtors, unfortunately to a large degree it has instead become a means to defraud creditors. They reported that since 1994 some lawyers have even developed a business of so-called "bankruptcy planning," in which advice is provided with the intention of assisting a firm in avoiding as many of its liabilities as possible by enabling the firm to take advantage of the defective bankruptcy legislation and the competition among governmental institutions. In certain cases, the lawyers designed a chain of bankruptcies to prevent a creditor from collecting its debt: a loan was obtained with a guarantee, and after the assets were transferred, both the debtor and the debtor's guarantor filed bankruptcy petitions, leaving the creditor with no party from whom to claim. In such circumstances, the appointed liquidation committees find their work very difficult. Given the small amount of assets left and the little chance of recovery in such cases, creditors usually have little incentive to demand a vigorous examination of the debtor's financial details and a complete investigation into the real reasons for the bankruptcy. However, a few cases were noted in which in-depth investigation by the authorities led to the discovery and recovery of assets dissipated by the companies; but such cases were clearly in the minority.

Inadequacy of bankruptcy institutions and laws

There was a general consensus that the most serious problem with the Chinese and Shenzhen bankruptcy laws was the lack of applicable, detailed, clearly-written legal rules. Currently, the Chinese Bankruptcy Law contains only forty-three articles. — ⁶². The Shenzhen Bankruptcy Regulations, in turn, contain ninety-three provisions. Although the Shenzhen Regulations (and the Bankruptcy Division Procedures) supplement the Chinese Bankruptcy Law in many areas, nevertheless the legislation

July 10, 1998, published in *Renmin Ribao (People's Daily)*, July 11, 1998.

⁶². And at that length it is the longest national special legislation. In addition, the Company Law of 1993 as amended in 1999 has 10 articles dealing with company bankruptcy. THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA, *supra*, note 21, Ch. 8, arts. 189-198. The Civil Procedure Law as amended in 1991 includes eight articles on the bankruptcy of legal person enterprises other than SOEs and companies. CIVIL PROCEDURE LAW, Ch. 19, arts. 199-206.

continues to be inadequate to resolve many of the issues that arise in Shenzhen bankruptcies.

This lack of detail can lead to unintended consequences, such as judicial interpretations that ironically appear to run contrary to the underlying purpose of the bankruptcy provision. For example, Article 11 of the Chinese Bankruptcy Law stipulates that after a bankruptcy case is accepted by the People's Court, any procedure to enforce other civil obligations against the debtor shall be stayed. The Supreme People's Court has held that this rule regarding the stay should be applied to the situation, *inter alia*, where the trial of the dispute has been finished, but the execution has not been completed.⁶³ This opinion indicates that once the trial and execution are completed, the dispute or claims shall not be addressed in the bankruptcy proceeding. As such, where a company with assets in several mainland jurisdictions runs into financial difficulty, this interpretation of the Supreme Court often leads to a race to grab the corporate assets; competing creditors and courts under the influence of the local protectionism rush to complete the local trial and the execution of the debtor's assets, sometimes even with unlawful measures. This practice has at times rendered rescue and reorganization more difficult, if not impossible. In some cases, the same piece of property has been "claimed" by different courts from different jurisdictions, and certain courts have even back-dated their documents to justify their orders of execution. As a result, the Supreme People's Court attempted to stop this practice by adopting a new rule in a later circular, which stipulated that any People's Court should not enter a decision in a case if the dispute over the jurisdiction is not settled. Any decision that is rushed to judgment shall be annulled by the upper-level court on the ground of procedural violation.⁶⁴

Other problems are caused by gaps in the legislation. One example noted by the judges was that under the Chinese Bankruptcy Law, the liquidation committee may not be established until after a bankruptcy order is entered.⁶⁵ However, neither the Chinese Bankruptcy Law nor the Shenzhen Bankruptcy Regulations provides any guidance as to who should be in charge of the debtor's assets in the gap period between the court's acceptance of the bankruptcy petition and its issuing of the bankruptcy order.⁶⁶ To address this omission, the Shenzhen Bankruptcy Court has

⁶³ SUPREME COURT'S OPINIONS, *supra* note 9, §12(1) at 1867.

⁶⁴ Certain Provisions of the Supreme People's Court Opinions Concerning Strict Implementation of the Civil Procedure Law of the PRC in Economic Trials, Dec. 22, 1994, printed in the Supreme Courts Opinions, *supra* note 9, vol.2 (1993-1996) at 439.

⁶⁵ Chinese Bankruptcy Law, art. 24. It provides that the liquidation committee shall be established by the People's Court within 15 days of the bankruptcy declaration.

⁶⁶ This is an important issue, since it is not uncommon for a company to try to improperly dispose of assets during this period.

developed the practice of creating a supervisory committee to function during this period. In Shenzhen, once a court accepts a bankruptcy case, the supervisory committee will monitor the activities of an enterprise, particularly in relation to its continuing business operations and asset dispositions. Once a bankruptcy order is made, the supervisory committee will then change its name to liquidation committee and will be responsible for handling the liquidation. But without any legislative guidance, the court is unable to clearly define the precise legal status of the supervisory committee and its scope of authority during the gap period, and conflicts still arise.

The liquidators and judges agreed as to the difficulty in defining the legal status of the supervisory committee in charge of the assets of the debtor during the gap period. They offered some examples to illustrate the situation. In some cases concerning the Public Security Bureau, the People's Procuratorate or the SAIC refused to allow a supervisory committee to have its own seal, on the ground that the committee lacked legal authority. In other cases, public utility companies suspended their services to the debtor in clear disregard of the repeated requests from a supervisory committee to restore the operation of services to the troubled enterprise.

Also missing from national legislation is the standard of compensation to be paid to the liquidation committee. As a result, the court has to exercise its discretion on compensation issues on a case-by-case basis. To address this problem, in Shenzhen the People's Court has set out the compensation standards of the liquidation committee based on the amount of the bankruptcy assets. There are five categories in the Court's provisions:

- RMB 20,000-50,000 if the assets total less than RMB 500,000;
- RMB 50,000-100,000 if the assets total between RMB 500,000 and 1 million;
- RMB 100,000-150,000 if the assets total between RMB 1 million and 5 million;
- RMB 150,000-200,000 if the assets total between RMB 5 million and 10 million; and
- RMB 200,000-300,000 if the assets total more than RMB 10 million.

The standards may be subject to the court's further adjustment according to the complexity of the particular case.⁶⁷ However, some of the lawyers reported that in some cases they could not receive any compensation at all, in part because of the lack of funds due to rampant fraudulent activities or the adoption of the social policy to provide workers with a maximum settlement. As a result, the People's Court may have to appoint

⁶⁷. XU, *supra* note 33, at 148-49.

certain lawyers or firms as liquidators in some easy cases as a means to compensate them for their previous losses.

One of the most difficult areas involves the failure of the current legal regime to adequately establish which obligations are provable in bankruptcy. Perhaps the best example is in regard to set-off, where the statutory language is too vague to be of much utility. Article 33 of the Chinese Bankruptcy Law merely states that if a creditor owes debts to the bankrupt enterprise, set-off may be allowed before the liquidation. Without any legislative standards to apply, the judges therefore consider themselves unable to comfortably resolve debates arising as to set-off.

Other problems arise from the failure of the legislation to specify who should file and register special claims, which include workers' wages, workers' social and unemployment insurance premiums, and taxes owed to the state. The Shenzhen Bankruptcy Court imposes this legal duty on the debtor, which is best placed to know the amounts of these claims. Nevertheless, in practice, it proves difficult to enforce this duty. Since the debtor's management officers rarely have any meaningful assets of their own compared to the large sum of these claims, they would be unable to answer personally for failing to exercise their legal duty to register these debts.

Moreover, the failure of the bankruptcy laws and regulations to define the term "obligation" leads to the filing of further unexpected claims. According to a commonly accepted theory, obligations may include both monetary claims and the performance of specific conduct.⁶⁸ Consequently, in some bankruptcy cases certain workers have even sought for the court to handle their claims for the loss of their opportunity to obtain membership in the Communist Party due to the dissolution of their enterprises after being declared bankrupt.

However, the lawyers also stressed that some accepted limits to the scope of obligations had developed in liquidation practice in Shenzhen. They noted that in addition to some general provisions of the Chinese Bankruptcy Law, Article 64 of the Shenzhen Bankruptcy Regulations excludes the following from the scope of a provable obligation: interest on unpaid debts accrued after the bankruptcy declaration; expenses incurred by creditors to participate in bankruptcy proceedings; claims that fail to be registered within the statutory period; claims that have lost the protection of the statutory limitation; and unexecuted administrative fines and confiscation.⁶⁹

⁶⁸ In China, a socialist country with a civil law background, the prevailing view has been that an "obligation" must be based on relations concerning property rights. However, the argument that obligation should be extended to cover certain non-property relations, such as personal relations, has indeed been raised by some scholars. YU QUANNENG & MA JUNJU, *XIANDAI MINFAXUE, STUDY OF MODERN CIVIL LAW* 424 (in Chinese, 1995).

⁶⁹ CHINA LAWS FOR FOREIGN BUSINESS, *supra* note 22, at 25352-53.

Another interesting shortcoming in the law identified by the judges involved the distribution of the property of the estate. It is not unusual in an enterprise bankruptcy that the only asset that remains after the property of the bankrupt proves insufficient to satisfy the creditors is the company's business license. In practice, this could prove to be a valuable asset because many business licenses are subject to state quotas and thus would have a market value. However, under regulations such as the Foreign Investment Enterprises Liquidation Procedures promulgated by the Ministry of Foreign Trade and Economic Cooperation in 1996, the business license of an enterprise must be returned to the state authority upon the cancellation of the enterprise's registration at the conclusion of the liquidation.⁷⁰ Therefore, a business license cannot be traded regardless of the buyer's quality and strength. As a result, at a minimum, this rigid state regulation prevents the court and the liquidation committee from maximizing the value of the corporate assets for the benefit of creditors; in other cases, it also prevents the successful reorganization of an enterprise and the saving of jobs.

The liquidators identified other problems that arise in making distributions to creditors, such as the making of certain unclassified payments to the government. For example, an SOE debtor may have to pay the state for its right of land use. However, the real estate market was not officially open until the Constitutional Amendment legitimized the practice in 1988.⁷¹ Thus, the Chinese Bankruptcy Law, dating from 1986, understandably fails to include a provision regarding this practice. Nevertheless, in many cases the liquidation committee must define the legal status of such payments in order to rank the priority of the claims. If these payments are treated like state levies, the government may enjoy priority; but if they are treated as contract rights, the state must wait in line and share *pari passu* with other unsecured creditors.

The overall inefficiency of the bankruptcy system and the limited

⁷⁰ Foreign Investment Enterprises Liquidation Procedures, art. 33. The Procedures were approved by the State Council on June 15, 1996, and an English translation was published in CHINA L. & PRAC. 37-44 (Nov. 1996). Wang Fuxiang has further developed his own list of inclusions and exclusions from the property of the estate. For instance, in his view, the funds of a trade union should not be the bankrupt's assets, but rather should belong to members of the union; dividends that were declared long before the bankruptcy petition but have not been taken by the shareholders should likewise not be included in the bankrupt's assets; and the awards given by the bankrupt to its employees for their distinguished contributions to the enterprise should not be taken back from them. WANG, *supra* note 19, at 54-55.

⁷¹ Article 10(4) of the Constitution of the PRC of 1982 prohibited any organization or individual from dealing with any land rights including sale or leasing. The article was amended on April 12, 1988 to permit the transaction of rights of land use, subject to regulation. See art. 2 of the Amendment of 1988 to the Constitution, published in the Bureau of Legislative Affairs of the State Council of the PRC (compilation), LAWS AND REGULATIONS OF THE PEOPLE'S REPUBLIC OF CHINA GOVERNING FOREIGN-RELATED MATTERS (1949-1990), vol. 1 301 (1991).

ability to increase the size of the bankruptcy estate deters creditors from taking an active interest in participating in bankruptcy proceedings. For example, although the Shenzhen Bankruptcy Court has tried to increase the judicial transparency by inviting as many creditors as possible to attend bankruptcy proceedings, few creditors actually attend. Some of the lawyers noted that the courts and many of the parties participating in bankruptcies have developed an overly-negative view of the possible results that may be achieved in bankruptcy, with the result that the insolvency procedures are almost always used to liquidate the assets of an insolvent company rather than applied with a view to reorganize or rehabilitate a company in financial distress. They pointed out that as a result, almost all bankruptcy petitions are filed at a very late stage when it is nearly impossible rescue a company and that distributions to creditors are quite low.⁷² Therefore, the Shenzhen practitioners argued that the application of bankruptcy standards should be relaxed to encourage earlier filing of petitions. They believe that the acceptance of such bankruptcy cases would not cause a massive increase in the number of bankruptcies, but rather would play an important role in leading the various parties to enter into settlements and corporate reorganization and, thus, would provide creditors with better protection. Moreover, both the judges and lawyers agreed that Shenzhen must focus on developing workable and effective reorganization procedures.

Ultimately, however, for a “corporate rescue” culture to emerge will require the emergence of a clearer professionalism among Shenzhen’s lawyers and accountants. The Shenzhen judges and lawyers acknowledged that the standard of practice of local insolvency practitioners needs to be improved. More training programs must be designed that focus on a variety of areas, including legal analysis, accounting principles, investigation, the evaluation of claims, and the collecting and liquidating of assets. The Shenzhen law and accounting firms need to take the lead in ensuring that this occurs. The emergence of a rescue culture would also increase the likelihood that creditors would play a more active role in the proceedings.

Cross-border insolvency

Cross-border insolvency, particularly in cases involving companies with assets in both the Shenzhen SEZ and the Hong Kong SAR, has become a concern of growing importance in Shenzhen. Unfortunately, however, there is a dearth of applicable cross-border insolvency law in Mainland China.⁷³ In some cases, the bankruptcy judges are confronted with in-bound

⁷². See *supra* note 39 and accompanying text.

⁷³. Today, China does not have any national legislation that may be specifically applied to

cases in which Hong Kong liquidators or creditors are seeking assets in Shenzhen. Others involve out-bound matters where the Shenzhen liquidation committees seek assets located in Hong Kong. The judges and lawyers all agreed that cooperation ought to be increased in cross-border insolvencies involving Shenzhen and Hong Kong. The judges noted that they have held discussions on this topic with officials from the Hong Kong Official Receiver's office and have raised the possibility of establishing certain mechanisms in this area. A formal mechanism or high level agreement would be necessary, because the sensitivity of the relations between the Hong Kong SAR and the mainland under the principle of "one country, two systems" excludes any local People's Court from individually dealing with the Hong Kong SAR on matters involving judicial cooperation. Thus, the formation of any cross-border insolvency framework must be negotiated by the Supreme People's Court and the Hong Kong SAR judiciary or government.⁷⁴

In this regard, it is interesting to note an older case and recent developments. A 1990 decision of a People's Court in Guangdong Province, *Liwan District Construction Company v. Euro-America China Property Limited*,⁷⁵ involved cross-border insolvency issues. The case involved a contract dispute between a mainland construction company and a Hong Kong property company that had entered into an agreement providing for the development of two new towns in Guangdong. The Hong Kong party was wound up, and the Supreme Court of Hong Kong appointed a liquidator. The Guangdong Court refused to allow the liquidator to represent the Hong Kong company in the Chinese proceedings concerning the performance of the contract, holding that the Hong Kong liquidator lacked the authority to do so. The court also found that the agreement between the joint venture parties had been frustrated as a result of the loss of the legal capacity of the Hong Kong party following the Hong Kong liquidation.

The Guangdong Court adopted a "territoriality approach" in resolving this cross-border insolvency issue. A territoriality approach is one

cross-border insolvency, and the members of the Drafting Group of the New Bankruptcy Law are still divided on how best to deal with this topic. For a recent discussion on the current conditions of Chinese cross-border insolvency practice, see Shi Jingxia, "Chinese Cross-Border Insolvencies: Current Issues and Future Developments", 10 INT. INSOLV. REV. 33 (2001).

⁷⁴ Since the reunification, the Supreme People's Court of China has concluded two such agreements: with the High Court in 1998 on the service of judicial documents, and with the Department of Justice of Hong Kong in 1999 on the mutual recognition and enforcement of arbitral awards. This practice has made it clear that although Article 95 of the Basic Law of the Hong Kong Special Administrative Region allows the Hong Kong SAR to maintain judicial relations with other regions of mainland China, it must be based on a framework established by the top authorities of both jurisdictions.

⁷⁵ For the case digest and detailed discussion, see *Liwan District Construction Company v. Euro-America China Property Ltd.*, reported and commented on by Donald J. Lewis & Charles D. Booth, *Case Comment*, 6 CHINA L. & PRAC. 27 (1990).

in which a local court refuses to recognize the extraterritorial scope of a foreign jurisdiction's laws and refuses to allow a foreign representative (e.g., a liquidator) to claim the assets of the foreign company that are located within the jurisdiction of the local court.⁷⁶ Although the Guangdong Court did not refer to any of the relevant provisions in Chinese insolvency legislation,⁷⁷ the Court's approach was consistent with such provisions.

The Shenzhen judges said that they were not aware of this case and had no comment on it. Nevertheless, they agreed that the Shenzhen court's own practice in regard to the recognition of foreign bankruptcies was consistent with the case and that they also endorsed the territoriality approach. The judges also noted a recent insolvency in which the Shenzhen court in fact applied such an approach. After the news of the failure of the Bank of Credit and Commerce International ("BCCI") reached Shenzhen, the Shenzhen Intermediate People's Court responded to the application of a mainland Chinese creditor by issuing an order to freeze the assets of BCCI's branch in Shenzhen. Later, BCCI's Shenzhen assets (which totaled US\$20 million) were distributed among domestic creditors (holding claims of US\$80) in accordance with Chinese bankruptcy procedure. The Court's position was that only domestic creditors were able to participate in the liquidation of BCCI in Shenzhen. This approach guaranteed a higher rate of recovery for mainland parties, but put foreign creditors at a disadvantage.⁷⁸

This territorial approach can be supported with reference to old Shenzhen bankruptcy law. For example, Article 5 of the old Shenzhen Bankruptcy Provisions (1986) provided that a bankruptcy declared abroad in accordance with the bankruptcy law of a foreign jurisdiction shall not have any effect on the assets of the insolvent company in the Shenzhen SEZ; however, this provision was not included in the current Shenzhen Bankruptcy Regulations (adopted in 1993).⁷⁹ Recently, the president of the Shenzhen Court submitted a proposal to the PRC national legislature to adopt a more flexible approach in cross-border insolvencies by permitting the application of a modified "universality doctrine" in certain situations. (In contrast to the territoriality approach, the "universality approach" is one in which a local court recognizes the extraterritorial scope of a foreign jurisdiction's laws and allows a foreign representative to claim the assets of the foreign company that are located within the jurisdiction of the local

⁷⁶ For further discussion of the "territoriality approach," see Charles D. Booth, *Living in Uncertain Times: The Need to Strengthen Hong Kong Transnational Insolvency Law*, 34 COLUMBIA J. TRANSNAT'L L. 389, 393-394 (1996) [hereinafter *Living in Uncertain Times*].

⁷⁷ The then-existing legislation did not apply to the liquidation of the Hong Kong party to the joint venture. Lewis & Booth, *supra* note 75, at 32.

⁷⁸ XU, *supra* note 33, at 59-60.

⁷⁹ Interestingly, the recent draft of the New Chinese Bankruptcy law retains a provision analogous to old Article 5 of the Shenzhen Bankruptcy Provisions. See Wang, *supra* note 19.

court.⁸⁰) More specifically, the president of the Shenzhen Court argued for the adoption of a reciprocity approach in which Chinese courts would be permitted to recognize foreign bankruptcy orders and decisions from foreign jurisdictions that recognized bankruptcy orders and decisions made by the People's Courts in mainland China.⁸¹ The application of the territoriality approach would be retained for cases involving bankruptcies from foreign jurisdictions that failed to recognize PRC bankruptcies.⁸²

Even if the Shenzhen courts were willing to recognize foreign representatives, other legal impediments would frequently remain. For example, the liquidators identified several legislative provisions that create additional legal barriers for the extra-territorial recovery of corporate assets in China. Articles 34 and 35 of the Company Law stipulate that the shareholders of a closely held company shall not withdraw their capital contribution, but rather may only make transfers among themselves once the company is registered.⁸³ Also, Article 36 of the Implementing Regulations of the Sino-Foreign Equity Joint Venture Law stipulates that any transfer of a joint venture's registered capital must be approved by a unanimous decision of the board of directors.⁸⁴

However, the judges also discussed a recent case in which a Guangdong court adopted a more flexible and "universality-based" approach in a non-bankruptcy context and both recognized and applied a Hong Kong law. In this case, the Intermediate People's Court in Guangzhou accepted a petition filed by Hong Kong creditors seeking to enforce a Hong Kong default judgment in their favor against the mainland assets of a Hong Kong company. To the surprise of many mainland practitioners, the court not only allowed the recovery, but also directly applied the Money Lenders Ordinance of Hong Kong⁸⁵ even though no agreement was in place between mainland China and the Hong Kong SAR on the mutual enforcement of judgments.⁸⁶

⁸⁰. For further discussion of the "universality approach," see Booth, *Living in Uncertain Times*, *supra* note 76, at 393-394.

⁸¹. The Law Reform Commission of Hong Kong recently similarly suggested that recognition by Hong Kong should be applied on a bilateral, rather than a unilateral, basis. THE LAW REFORM COMMISSION OF HONG KONG, REPORT ON THE WINDING-UP PROVISIONS OF THE COMPANIES ORDINANCE 213 (July 1999).

⁸². XU, *supra* note 33, at 196.

⁸³. For an English translation, see THE LAWS OF THE PEOPLE'S REPUBLIC OF CHINA, *supra* note 53, at 301.

⁸⁴. For an English translation, see CHINA LAW REFERENCE SERIES (1996-2000), Vol. 2, Part II, *Economic Law*, §2310: 10-25. For a discussion of this issue in the context of foreign investment enterprises ("FIEs") in Beijing, see Xianchu Zhang & Charles D. Booth, *Beijing's Initiative on Cross-Border Insolvency: Reflections on a Recent Visit of Hong Kong Professionals to Beijing*, 31 HONG KONG L.J. 312, 313-314 (2001).

⁸⁵. Hong Kong SAR, Ch. 163, Money Lenders Ordinance.

⁸⁶. For a report of the decision and comments in English, see Mary Xu & Wang Tianxi,

None of the judges or liquidators was aware of any cases in which a Hong Kong creditor or liquidator entrusted a Shenzhen lawyer or law firm to recover a Hong Kong bankrupt's assets in Shenzhen or to enforce a liquidation or bankruptcy order against a Hong Kong debtor's assets in Shenzhen.

These issues involving the extraterritorial effect of Chinese insolvency laws also arise domestically within the mainland. In a recent case, these issues overlapped with the legal effect of the bankruptcy of a parent company on its wholly owned subsidiaries.⁸⁷ When an insolvent company was in the midst of bankruptcy proceedings in Shenzhen, it was discovered that the company had a wholly-owned subsidiary in another Chinese jurisdiction. The Shenzhen liquidation committee asserted its rights to include the subsidiary's assets in the Shenzhen bankruptcy proceedings. Depending on the conditions of the subsidiary, the Shenzhen liquidation committee could either (1) include the subsidiary's assets in the Shenzhen proceedings or (2) sell the subsidiary separately and then include the proceeds in the bankruptcy assets of the bankrupt. The subsidiary vigorously opposed these actions by the Shenzhen liquidation committee on the ground that they amounted to an unjustified intervention into its business autonomy. The court finally accepted the liquidator's universality argument for jurisdiction over the subsidiary.⁸⁸

In regard to out-bound cross-border insolvencies, the judges and liquidators reported that although they have handled cases in which mainland debtors have assets in Hong Kong, the Shenzhen Bankruptcy Court has never attempted to recover them. According to the judges, there are two primary reasons: (1) due to the lack of a judicial assistance agreement

Meidaiduo Financial Co., Ltd. v. Ruichang Real Estate Co., Ltd. et al. Involving a Loan Contract, CHINA L. 102-104 (Zhang Qing, trans., Aug. 2000); Zhang Xianchu, *Foreign Law Applied by the People's Court in China*, CCH CHINA LAW UPDATE 15, 24 (Aug. 2000).

⁸⁷. As noted above, Chinese bankruptcy legislation fails to include any rules dealing with the legal effect of the bankruptcy of a parent company on its wholly owned subsidiaries. See *supra* text accompanying notes 53-54.

⁸⁸. In this case, it is interesting to note that the Shenzhen court, although agreeing that the property of the subsidiary should be disposed of, took a more cautious position. It believed that to consolidate the liquidation of a subsidiary with that of its parent company could cause other problems, including the following: disregarding the subsidiary's independent personality; causing unfairness for the creditors of the subsidiary who are forced to join the bankruptcy proceedings of the parent company; and producing social waste and instability. Therefore, the court suggested other options. For example, if a subsidiary is found to be a profitable and healthy enterprise, the court should protect the company's competitive edge by encouraging a merger or sale of the unit as a whole at market price. In contrast, where the subsidiary is experiencing financial difficulties, but nevertheless may manage to repay all or most debts, it should be declared bankrupt or liquidated through a separate proceeding. It could also be possible to leave the decision to the subsidiary and its creditors, who may choose to repay the parent company's investment and transform the subsidiary into an independent enterprise under a new ownership structure. XU, *supra* note 33, at 202-04.

between the mainland and the Hong Kong SAR for bankruptcies, a liquidation committee controlled and supervised as an entity by a People's Court cannot directly contact the authorities of the Hong Kong SAR (including the Official Receiver and the court); and (2) legal costs in Hong Kong are prohibitively high.

The liquidators noted that in a few recent cases the assets of bankrupt Shenzhen enterprises had been transferred to Hong Kong, in some instances as part of an intentional plan to defraud the enterprise's creditors; and in others, as part of normal cross-border investment by the debtor. In these cases, the liquidation committees hoped to attempt to recover these assets, and they explained the advantages of pursuing such a strategy to the creditors in an effort to gain their approval to fund recovery actions. However, in each case, the same reasons as those identified by the judges (i.e., lack of a judicial assistance arrangement and the high cost of legal services in Hong Kong) prevented them from carrying out their plans. Several of the liquidators held the view that it would be more cost-effective to use debt collectors to pursue claims in Hong Kong rather than to resort to lawyers and the commencement of formal winding-up or civil proceedings; but they all acknowledged that this had not yet been attempted.

III. OVERALL OBSERVATIONS

The views of the Shenzhen bankruptcy judges, lawyers, and legislators demonstrate that Shenzhen has taken important steps to improve upon the Chinese Bankruptcy Law, namely: the promulgation of the Shenzhen Bankruptcy Regulations, which have supplemented the national law in many important areas; the establishment of a separate bankruptcy branch within the People's Court, which has helped to develop an experienced body to consider bankruptcy problems; and the willingness to create innovative legislative and judicial solutions. The national insolvency law reform process would benefit greatly if those involved took a close look at the Shenzhen experience.

The information from the Shenzhen interviews, nevertheless, draws a vivid picture of several areas of continuing concern, including:

- the continuing tensions between protecting the judicial independence of the bankruptcy courts and allowing involvement of, and control by, the government authorities;
- the underdevelopment of the other institutions necessary to the long-term success of the bankruptcy system;
- the lack of cooperation and coordination between the bankruptcy courts and other government authorities in Shenzhen and in other parts of the mainland in dealing with bankruptcy cases;

- the fact that although Shenzhen's bankruptcy law is more modern and detailed than the Chinese Bankruptcy Law, it too is in need of improvement;
- the fact that a corporate rescue culture still does not exist in Shenzhen; and
- the need to foster cross-border cooperation in general, and with Hong Kong, in particular

It is clear from the interviews that difficult and sensitive issues still need to be addressed as the SEZ struggles with how to resolve the conflicts between the bankruptcy courts and state authorities. This tension results from the attempt to apply an insolvency law primarily based on market-based discipline within a system in which many government units wish to retain their strong control over SOEs and remain governed by an older, state-oriented ideology. Interviewees repeatedly noted that many government authorities remain deeply involved in bankruptcy proceedings in Shenzhen, as well as in other regions of China. The reasons are more political than legal, for what is at issue is the attempt by these authorities to maintain the state's direct interest in asset preservation and social stability. From the perspective of some state authorities, the strict enforcement of the bankruptcy law may inevitably lead to the loss of public ownership as a cornerstone of a socialist country and the collapse of SOEs as a social and political safety-net in China.⁸⁹ On the other hand, the bankruptcy courts see the application of the bankruptcy regime as an instrument of reform that furthers antithetical government policy objectives. The inability to resolve these two contradictory perspectives often results in confusing and frustrating resolutions in individual cases.⁹⁰ Of course, at its core, the Chinese system is an administrative system and, as a result, the resolutions of the above tensions will, at least in the short term, most likely favor administrative domination over judicial independence and judicial control of the bankruptcy process. This, in turn, will distort the functions played by the courts in bankruptcy proceedings.

The excessive administrative involvement arises in great part because of the lack of developed social institutions to support the function of market discipline. For example, it is estimated that if all SOEs began operating according to commercial considerations some thirty million people would become unemployed.⁹¹ As a result, until adequate social welfare and

⁸⁹. For example, President Jiang Zemin has repeatedly made it clear that China is a socialist market economy (which it cannot be if public ownership is not the main component) and that expanding the state-owned economy is the basic guarantee for building socialism with Chinese characteristics. See *Renmin Ribao* (People's Daily), Nov. 21, 1995.

⁹⁰. Ron W. Harmer, *Comparison of Trends in National Law: The Pacific Rim in Symposium Bankruptcy in the Global Village*, 23 BROOKLYN J. INT'L L. 139, 161-162 (1997).

⁹¹. MARK A. GROOMBRIDGE & CLAUDE E. BARFIELD, *TIGER BY THE TAIL: CHINA AND THE*

insurance systems are in place, it is impossible for Chinese insolvency law to be applied on a larger scale. Similarly, the Chinese state-owned banking sector must also be stabilized.

Other institutions are also lacking, and the general social and business environment in China is far from adequate for the operation of a market-based bankruptcy law. Professor Ian Fletcher has observed that a "further feature of the operation of insolvency law is that it purports to embody a distinctive philosophy regarding the ethical properties which are to be observed in relationships between the creditors and their insolvent debtor, and amongst the creditors themselves as a group."⁹² This distinctive philosophy is notably absent from Shenzhen, as an underlying professionalism (as well as customs, conventions and commercial morality) has not adequately developed. These factors will likely evolve hand-in-hand with the development of the legal and accounting professions in general and the training of insolvency experts in particular. The current lack of expertise extends to a broad range of bankruptcy-related activities, including financial and forensic accounting, the evaluation of claims, and auction procedures.

The lack of cooperation between the Shenzhen Bankruptcy Court and other national and state institutions, together with the many inconsistencies, gaps and lack of workable definitions in the bankruptcy law (e.g., regarding the scope of obligations and liabilities) cause further problems. Among the most serious are the overall inefficiency in the administration of bankruptcies, the inability to combat fraudulent activities and punish wrongdoing by directors, and the low rate of distribution paid to creditors. However, in this regard, the Shenzhen Court has taken steps to improve enforcement. For example, in May 1999, twelve debtors were detained for their refusal to repay debts incurred through the use of fraudulent or improper means, the names of thirty-two debtors who failed to honor debt judgments were publicized, and a public report scheme was launched to encourage people to inform the relevant state authority of property conditions or activities of fraudulent debtors. The enforcement campaign in that month alone successfully collected debt payments of over RMB 56 million and made progress in executing approximately thirty judgments.⁹³

It is clear that the existing bankruptcy law regime in China is based almost solely on liquidation, with little attention and few provisions in the law focussing on corporate rescue or reorganization. This defect, as the Shenzhen judges and practitioners realize, not only ensures that virtually all

WORLD TRADE ORGANIZATION 28 (1999).

⁹² IAN F. FLETCHER, *THE LAW OF INSOLVENCY* 2 (2d ed. 1996).

⁹³ See the report in *Xiang Gang Shang Bao* (*Hong Kong Commercial Daily*), June 9, 1999.

firms entering into bankruptcy proceedings have little hope of survival, but also exacerbates the knock-on effects on the Chinese social security and financial systems. The long-term success of insolvency law in China is, to a great extent, dependent on the formation of a corporate rescue culture. According to Professor Wang Weiguo, despite the availability of provisions on reorganization in the Chinese Bankruptcy Law, of the nearly 10,000 bankruptcy cases accepted by the People's Court in the past ten years, the number of cases in which these provisions have been invoked is close to zero!⁹⁴ The improvement of the current law through the enactment of more effective corporate rescue provisions, and of incentives to use the new procedures, is a matter of pressing concern. Shenzhen would be the perfect jurisdiction in China in which to enact a trial implementation of a new reorganization law.

Lastly, the integration of the regional economy of the Shenzhen SEZ and the Hong Kong SAR necessitates the establishment of a cooperative framework between the two jurisdictions for handling cross-border insolvency issues. Granted, the significant differences in the economic systems, accounting standards, and the roles played by government should not be understated. Nevertheless, the Shenzhen bankruptcy judges and practitioners acknowledge the need to address these differences and to develop rules leading to the creation of a scheme adopting a more universality-oriented approach, at least on a regional scale. Unfortunately, the 2000 draft of the New Chinese Bankruptcy Law has not yet taken this step.⁹⁵ Perhaps here too, the issue could be reconsidered in the context of promulgating a trial cross-border insolvency cooperation scheme for application in insolvencies involving the Shenzhen SEZ and the Hong Kong SAR.

The challenges facing the continuing development of China's insolvency law regime are great, and bankruptcy law reform in China is unlikely to be effective unless it is accompanied by the reforms of related supporting institutions. But if the attitudes of the Shenzhen bankruptcy judges and practitioners whom we interviewed are indicative, it is likely that solutions to many of these problems will emerge in Shenzhen before they appear elsewhere in China.

⁹⁴. WANG, BANKRUPTCY LAW, *supra* note 12, at 238.

⁹⁵. See *supra* notes 13 and 74.

